CHAPTER 2

Financial Statements and the Annual Report

OVERVIEW OF EXERCISES, PROBLEMS, AND CASES

Learning Outcomes	Exercises	Estimated Time in Minutes	Level
1. Describe the objectives of financial reporting.			
2. Describe the qualitative characteristics of accounting information.	1	10	Easy
3. Explain the concept and purpose of a classified balance sheet and prepare the statement.	2	10	Mod
	3	10	Easy
	5	10	Easy
	12*	10	Mod
4. Use a classified balance sheet to analyze a company's financial position.	4	10	Easy
5. Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement.	6	10	Easy
	7	10	Mod
	12*	10	Mod
	13*	15	Mod
	14*	5	Easy
6. Use a multiple-step income statement to analyze a company's operations.	8	10	Easy
	13*	15	Mod
	14*	5	Easy
7. Identify the components of the statement of retained earnings and prepare the statement.	9	10	Mod
	12*	10	Mod
8. Identify the components of the statement of cash flows and prepare the statement.	10	10	Easy
9. Read and use the financial statements and other elements in the annual report of a publicly held company.	11	20	Diff

*Exercise, problem, or case covers two or more learning outcomes
Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

Learning Outcomes	Problems and Alternates	Estimated Time in Minutes	Level
1. Describe the objectives of financial reporting.	12*	45	Diff
2. Describe the qualitative characteristics of accounting information.	1	15	Diff
	2	15	Mod
	10*	35	Mod
	11*	20	Mod
3. Explain the concept and purpose of a classified balance sheet and prepare the statement.	3	50	Mod
4. Use a classified balance sheet to analyze a company's financial position.	4	20	Easy
	5	15	Mod
	10*	35	Mod
	12*	45	Diff
5. Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement.	6	30	Mod
	7	45	Mod
	11*	20	Mod
6. Use a multiple-step income statement to analyze a company's operations.			
7. Identify the components of the statement of retained earnings and prepare the statement.			
8. Identify the components of the statement of cash flows and prepare the statement.	8	30	Mod
	12*	45	Diff
9. Read and use the financial statements and other elements in the annual report of a publicly held company.	9	30	Diff

*Exercise, problem, or case covers two or more learning outcomes
Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

Learning Outcomes	Cases	Estimated Time in Minutes	Level
1. Describe the objectives of financial reporting.			
2. Describe the qualitative characteristics of accounting information.	5	30	Mod
3. Explain the concept and purpose of a classified balance sheet and prepare the statement.			
4. Use a classified balance sheet to analyze a company's financial position.	1	30	Mod
	2	20	Mod
	6*	30	Mod
5. Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement.			
6. Use a multiple-step income statement to analyze a company's operations.	6*	30	Mod
7. Identify the components of the statement of retained earnings and prepare the statement.			
8. Identify the components of the statement of cash flows and prepare the statement.	3	25	Mod
9. Read and use the financial statements and other elements in the annual report of a publicly held company.	4	20	Mod

*Exercise, problem, or case covers two or more learning outcomes
Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

QUESTIONS

1. The primary concern to an investor is the future cash to be received from the investment. However, this does not mean that the cash flows of the company that has been invested in are not relevant. A relationship exists between the cash flows to the investor and those to the company. For example, a company that does not consistently generate sufficient cash flows from its operations will not be able to pay cash dividends to the investors over a sustained time.

2. The understandability characteristic does not imply that someone must have an extensive accounting background to be able to use financial statements. However, accounting information should be understandable to those who are willing to learn to use it properly. In other words, the information should make sense to someone who spends the time required to have a basic understanding of accounting.

3. Relevance is the capacity of accounting information to make a difference in a financial decision. For example, an income statement is relevant when the use of it has at least the potential to make a difference in an investment decision.

4. Comparability is the quality of accounting information that allows comparisons to be made between or among companies. Without it, financial statements would be very limited in their value. Financial decisions require choices to be made about the investment of limited resources. Investors need assurance that the financial statements of companies that they are considering as investments are comparable.

5. Comparability is the quality of information that allows for comparisons to be made between two or more companies, whereas consistency is the quality that allows for comparisons to be made within a single entity from one accounting period to the next.

6. The concept of materiality is closely related to the size of a company. For example, assume that a company must decide whether a $500 expenditure that will benefit future periods should be expensed immediately or capitalized (i.e., recorded as an asset). The decision cannot be made without considering the amount in relation to the size of the company. An amount that is immaterial for a large multinational corporation may be material for a smaller business.

7. The IASB recognizes the same qualitative characteristics for useful information as does the FASB. The two groups are working together on a joint conceptual framework project, of which the chapter on qualitative characteristics is completed.

8. A current asset is an asset that a company expects to realize in cash, sell, or consume during its normal operating cycle. Therefore, accounts receivable, inventory, and supplies all meet this definition and are classified as current assets. By their nature, the benefits from each of these assets will be realized during the normal operating cycle of the business.

9. The note payable will be classified on the balance sheet as long term until *one year* from its maturity date. At that time, it should be reclassified from long term to current because it will be paid within the next year. Any liability that will mature within one year of the date of the balance sheet should be classified as current, regardless of the original term of the loan (five years in this case).

10. Both capital stock and retained earnings represent claims of the stockholders on the assets of the business. They differ, however, in the source of those claims. Capital stock represents the claims of the stockholders that arise from their contributions of cash and other assets to the business. Retained earnings represent the accumulated earnings, or net income, of the business since its inception less all dividends declared during that time.

11. Working capital is an absolute measure of liquidity. That is, it is the total *dollar* amount of current assets minus current liabilities. One of the problems with working capital as a measure of liquidity is that it does not allow someone to compare the relative liquidity of two companies of different sizes. Even within a single company, it may be difficult to compare the relative liquidity of the company over time if the company has grown. The current ratio (current assets divided by current liabilities) overcomes these deficiencies by focusing attention on the relative size of the current assets and current liabilities.

12. Capital structure refers to the right side of a balance sheet. All items on the right side of the balance sheet represent claims against the assets of the business: liabilities are the claims of outsiders, and stockholders' equity is the claim of the owners on the assets of the business. The capital structures of all companies differ in that some companies rely more on outsiders to provide assets, whereas others rely more on the owners to provide the necessary assets to run the business.

13. The single-step income statement shows a subtotal for all expenses and deducts this amount from total revenues. The weakness of the single-step form for the income statement is that relationships between key items on the statement are not highlighted. For example, the relationship between sales revenue and the cost of the products sold is very important for a product-oriented company. The difference between the two amounts is called gross profit and would appear on a multiple-step statement but not in the single-step form.

14. A statement of retained earnings links the income statement and the balance sheet in the following way. A statement of retained earnings shows the beginning balance in the account, the addition (deduction) to the account for the net income (loss) of the period, and any deduction from the account for dividends. The beginning balance in Retained Earnings is taken from the balance sheet at the end of the prior period. The income statement indicates the net income for the period. The ending balance in Retained Earnings appears on the balance sheet at the end of the period.

15. An audit of a set of financial statements does not ensure that the statements are free of error. Because of the sheer number of transactions entered into during a period of time, it would be impossible for an auditor to check every single transaction to determine that it was correctly recorded. Instead, through various types of tests, the auditor renders an opinion as to whether the statements are free of material misstatement.

16. The first note is the summary of significant accounting policies. As the name implies, the purpose of this note is to summarize all of the company's important accounting policies, such as those relating to the method of depreciating assets and the method for valuing inventories.

BRIEF EXERCISES

LO 1

BRIEF EXERCISE 2-1 OBJECTIVES OF FINANCIAL REPORTING

The overriding objective of financial reporting is to provide financial information to permit users of the information to make informed decisions. Financial statements do not report the value of the reporting entity, but should provide useful information to allow users to make estimates of the value of the entity.

LO 2

BRIEF EXERCISE 2-2 QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

The two fundamental qualities that make accounting information useful are relevance and faithful representation. Financial information is enhanced when it is understandable, comparable, and consistent.

LO 3

BRIEF EXERCISE 2-3 CLASSIFICATION OF ASSETS

Accounts receivable—CA

Land—NCA

Inventories—CA

Cash—CA

Furniture and fixtures—NCA

Office supplies—CA

Buildings—NCA

LO 4

BRIEF EXERCISE 2-4 WORKING CAPITAL AND CURRENT RATIO

Working Capital = Current Assets – Current Liabilities
Working Capital: $80,000 – $60,000 = $20,000

Current Ratio = Current Assets/Current Liabilities
Current Ratio: $80,000/$60,000 = 1.33 to 1

LO 5

BRIEF EXERCISE 2-5 MULTIPLE- VERSUS SINGLE-STEP INCOME STATEMENT

Lines that will appear on a multiple-step income statement, but not on a single-step income statement, are Gross profit, Total operating expenses, Income from operations, Excess of other revenues over other expenses, and Income before income taxes.

LO 6

BRIEF EXERCISE 2-6 PROFIT MARGIN

Profit Margin = Net Income/Sales =
($100,000 – $60,000 – $15,000 – $10,000)/$100,000 = $15,000**/$100,000* = 15%

Sales	$100,000*
– Cost of goods sold	60,000
= Gross profit	$ 40,000
– Total operating expenses	15,000
= Income before income taxes	$ 25,000
– Income tax expense	10,000
= Net income	$ 15,000**

LO 7

BRIEF EXERCISE 2-7 RETAINED EARNINGS

Ending retained earnings = $200,000 + $80,000 – $50,000 = $230,000*

Retained earnings, beginning balance	$200,000
Add: Net income for the year	80,000
Less: Dividends paid	(50,000)
Retained earnings, ending balance	$230,000*

LO 8

BRIEF EXERCISE 2-8 INVESTING AND FINANCING ACTIVITIES

The amount borrowed from the bank, $100,000, would be reported on the statement of cash flows as an inflow from financing activities. The amount used to buy a new piece of equipment, $80,000, would be shown on the statement of cash flows as an outflow from investing activities.

LO 9

BRIEF EXERCISE 2-9 ELEMENTS OF AN ANNUAL REPORT

In addition to the financial statements, an annual report usually includes the following items: a letter to the stockholders from either the president or the chair of the board of directors, a section describing the company's products/services and markets, the auditors' report, management discussion and analysis, and notes to the financial statements.

EXERCISES

LO 2

EXERCISE 2-1 CHARACTERISTICS OF USEFUL ACCOUNTING INFORMATION

1. materiality
2. relevance
3. faithful representation
4. consistency
5. understandability
6. comparability

LO 3

EXERCISE 2-2 THE OPERATING CYCLE

1. For a company that sells a product, the operating cycle begins when the cash is invested in inventory and ends when cash is collected by the company from its customers. Two Wheeler's operating cycle would be a minimum of 45 days (for cash sales) and a maximum of 75 days (for sales on credit: 45 days to sell the bike and 30 days to collect).
2. The operating cycle for Baxter, the manufacturer of the bikes, would normally be longer than Two Wheeler's. This is because a manufacturer incurs various costs to produce the bikes before it sells them to retailers such as Two Wheeler and eventually collects cash from the sales. On the other hand, the retailer only buys a finished good from the manufacturer and then sells it to the customer.

LO 3

EXERCISE 2-3 CLASSIFICATION OF FINANCIAL STATEMENT ITEMS

1. CA
2. SE
3. CL
4. CA
5. NCA
6. CA
7. CL
8. NCA
9. SE
10. LTL

LO 4

EXERCISE 2-4 CURRENT RATIO

1. Current Ratio = Current Assets/Current Liabilities

   December 31, 2011:

   Current Ratio = ($6,000 + $10,000 + $8,000)/($7,000 + $1,000 + $4,000)
   = $24,000/$12,000
   = 2.0 to 1

   December 31, 2012:

   Current Ratio = ($3,000 + $15,000 + $12,000)/($12,000 + $2,000 + $6,000)
   = $30,000/$20,000
   = 1.5 to 1

2. Baldwin's current ratio decreased from 2.0 at the end of 2011 to 1.5 at the end of 2012. In general, the higher the current ratio, the more liquid the company.

3. Cash decreased by 50%, from $6,000 to $3,000, and accounts receivable increased by 50%, from $10,000 to $15,000. Inventory also increased by 50%, from $8,000 to $12,000. Not only did Baldwin's current ratio decrease, but its current assets are also less liquid at the end of the year, with more invested in receivables and inventory and less in cash.

LO 3

EXERCISE 2-5 CLASSIFICATION OF ASSETS AND LIABILITIES

1. CA	**4.** NCA	**7.** CA
2. CL	**5.** CL	**8.** LTL
3. CA	**6.** CL	**9.** NCA

LO 5

EXERCISE 2-6 SELLING EXPENSES AND GENERAL AND ADMINISTRATIVE EXPENSES

1. Advertising expense—S
2. Depreciation expense—store furniture and fixtures—S
3. Office rent expense—G&A
4. Office salaries expense—G&A
5. Store rent expense—S
6. Store salaries expense—S
7. Insurance expense—G&A*
8. Supplies expense—G&A*
9. Utilities expense—G&A*

*Each of these could be classified as a selling expense if the cost is related in some way to the sales function; e.g., insurance on cars driven by salespeople could be classified as a selling expense.

LO 5

EXERCISE 2-7 MISSING INCOME STATEMENT AMOUNTS

	Sara's Coffee Shop	Amy's Deli	Jane's Bagels
Net sales	$35,000	**(3) $63,000**	$78,000
Cost of goods sold	**(1) 28,000**	45,000	**(7) 39,000**
Gross profit	7,000	18,000	**(6) 39,000**
Selling expenses	3,000	**(4) 6,000**	9,000
General and administrative expenses	1,500	2,800	**(5) 4,600**
Total operating expenses	**(2) 4,500**	8,800	13,600
Net income	$ 2,500	$ 9,200	$25,400

Solved as follows (in the order listed):

(1) $35,000 – $7,000 = $28,000
(2) $3,000 + $1,500 = $4,500
(3) $45,000 + $18,000 = $63,000
(4) $8,800 – $2,800 = $6,000
(5) $13,600 – $9,000 = $4,600
(6) $25,400 + $13,600 = $39,000
(7) $78,000 – $39,000 = $39,000

LO 6

EXERCISE 2-8 INCOME STATEMENT RATIO

Profit margin:

Net Income/Revenues = $45,000*/$134,800 = 33.4%

*$134,800 – $38,310 – $36,990 – $580 – $13,920 = $45,000

A profit margin of 33% indicates that for every dollar of sales, Holly Enterprises has $0.33 in net income. It would be beneficial to compare the company's profit margin with some of its competitors and with previous years.

LO 7

EXERCISE 2-9 STATEMENT OF RETAINED EARNINGS

LANDON CORPORATION
STATEMENT OF RETAINED EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 2012

Retained earnings, January 1, 2012		$130,520*
Add: Net income for 2012		145,480
Less: Dividends declared and paid		(40,000)
Retained earnings, December 31, 2012		$236,000

*Retained earnings, January 2, 2010		$ 0
Add: Net income:		
2010	$ 85,200	
2011	125,320	210,520
Deduct: Dividends:		
2010	$ 40,000	
2011	40,000	(80,000)
Retained earnings, December 31, 2011		$130,520

LO 8

EXERCISE 2-10 COMPONENTS OF THE STATEMENT OF CASH FLOWS

1. Paid for supplies—O
2. Collected cash from customers—O
3. Purchased land (held for resale)—O
4. Purchased land (for construction of new building)—I
5. Paid dividend—F
6. Issued stock—F
7. Purchased computers (for use in the business)—I
8. Sold old equipment—I

LO 9

EXERCISE 2-11 BASIC ELEMENTS OF FINANCIAL REPORTS

1. **Management discussion and analysis—**The information in this section of the annual report is prepared by management and is management's opportunity to explain various items that appear in the financial statements. Increases and decreases in various items are highlighted and reasons for these changes are given. The information in this section is not subject to any outside review or support. Users must rely on the integrity of management that the information contained in the report is reliable.

2. **Product/markets of company—**Management provides information in the annual report about the company's products and markets. The detail provided by management differs widely among companies, but most companies describe their various products and often show pictures of them. The distribution system for the products, i.e., whom the company sells to, is also described. Because the company's products and markets are a matter of public knowledge, they are subject to verification.

3. **Financial statements—**These are the responsibility of management and are normally prepared by the controller. They include the income statement, balance sheet, statement of changes in stockholders' equity, and statement of cash flows. The information provided in the financial statements is subject to verification as part of the external audit.

4. **Notes to financial statements—**These are also the responsibility of management, and they include detailed explanations about the various items appearing in the financial statements. The first note in most annual reports is a summary of the significant accounting policies, such as the company's inventory valuation methods and depreciation methods. The information included in the notes is subject to review by the independent auditors and is therefore highly verifiable.

5. **Independent accountants' report—**As the name implies, this report is prepared by the independent auditors. It includes information about the scope of the audit (the statements included in the audit), the auditing standards followed in conducting the audit, and an opinion as to the fairness of presentation of the financial statements. Because the public relies on the auditors to render an impartial opinion, the auditing profession is subject to a set of high ethical standards in performing audits.

MULTI-CONCEPT EXERCISES

LO 3,5,7

EXERCISE 2-12 FINANCIAL STATEMENT CLASSIFICATION

BS = Balance sheet; IS = Income statement; RE = Retained earnings statement

1. Accounts payable—BS
2. Accounts receivable—BS
3. Advertising expense—IS
4. Bad debt expense—IS
5. Bonds payable—BS
6. Buildings—BS
7. Cash—BS
8. Common stock—BS
9. Depreciation expense—IS
10. Dividends—RE
11. Land held for future expansion—BS
12. Loan payable—BS
13. Office supplies—BS
14. Patent—BS
15. Patent amortization expense—IS
16. Prepaid insurance—BS
17. Retained earnings—BS and RE
18. Sales—IS
19. Utilities expense—IS
20. Wages payable—BS

LO 5,6

EXERCISE 2-13 SINGLE- AND MULTIPLE-STEP INCOME STATEMENT

1. Sales—B
2. Cost of goods sold—B
3. Selling expenses—M*
4. Total revenues—S
5. Utilities expense—B
6. Administrative expense—M*
7. Net income—B
8. Supplies on hand—N
9. Accumulated depreciation—N
10. Income before income taxes—M
11. Gross profit—M

*This assumes that selling and administrative expenses are each headings for a group of expenses. If this is the case, they would appear only on a multiple-step income statement.

LO 5,6

EXERCISE 2-14 MULTIPLE-STEP INCOME STATEMENT

Profit margin:

Net Income/Sales = $614,200*/$1,200,000 = 51.2%

$1,200,000 – $450,000 – $60,800 – $75,000 = $614,200

Sales	$1,200,000
– Cost of sales	450,000
= Gross profit	$ 750,000
– Total operating expenses	135,800**
= Net income	$ 614,200*

**Total Operating Expenses = Selling Expenses ($60,800) + General and Administrative Expenses ($75,000) = $135,800

Gaynor Corporation has been very profitable on the basis of its very high profit margin of 51.2%. Before making an investment, however, you would want to consider how this ratio compares with that of prior years and with that of other companies in the same line of business.

PROBLEMS

LO 2 **PROBLEM 2-1 MATERIALITY**

1. Among the questions that might be answered by the analysis that was performed are these: Is the usage of any of the items cyclical? Is there a relationship between the usage of any two or more of the items? Is the amount being spent on these items material? Would it be feasible to set up an account at an office supply store for some of these items if they are used in large quantities? From this analysis, the company might decide to change the timing of its ordering to correspond to its need.
2. This question deals with the concept of materiality. It is likely this information would be more relevant for a real estate company than for a hardware store. Normally, a realtor would use more office supplies, relative to its use of other types of supplies, and thus the amount spent on office supplies would be more material to it than to a hardware store.

LO 2 **PROBLEM 2-2 COSTS AND EXPENSES**

1. **Display fixtures in a retail store—**Only a portion of the cost would appear in the period of acquisition; the fixtures should be depreciated over their useful lives.
2. **Advertising—**All.
3. **Merchandise for sale—**Only the cost of the merchandise sold during the current period would appear on the income statement; the remainder would appear as an asset on the balance sheet.
4. **Incorporation**—Because of the difficulty in determining the period over which benefits will be received from the costs necessary to incorporate, accounting standards require that these costs be expensed as incurred.
5. **Cost of a franchise—**This is a cost that should benefit several future periods, and only a portion should be expensed in the current period; the cost of the franchise should be treated as an intangible asset and amortized over the periods during which benefits are expected.
6. **Office supplies—**The portion of the supplies used should be recognized as an expense in the current period; the unused portion should be reported as a current asset.
7. **Wages and salaries—**All.
8. **Computer software**—Assuming that the software was purchased, an intangible asset should be recognized and a portion of the cost recognized as expense in each of the periods benefited.

PROBLEM 2-2 (Concluded)

9. **Computer hardware**—Only the portion of the cost associated with the benefits provided during the current period would be recognized as depreciation expense; the cost should be written off over the useful life of the hardware.

LO 3 **PROBLEM 2-3 CLASSIFIED BALANCE SHEET**

1. Classified balance sheet:

RUTH CORPORATION
BALANCE SHEET
DECEMBER 31, 2012

Assets			
Current assets:			
Cash		$ 13,230	
Accounts receivable		23,450	
Inventory		45,730	
Prepaid rent		1,500	
Office supplies		2,340	
Total current assets			$ 86,250
Long-term investments			85,000
Property, plant, and equipment:			
Land		$250,000	
Automobiles	$112,500		
Less: Accumulated depreciation	22,500	90,000	
Buildings	$200,000		
Less: Accumulated depreciation	40,000	160,000	
Total property, plant, and equipment			500,000
Intangible assets:			
Patents			40,000
Total assets			$711,250
Liabilities			
Current liabilities:			
Accounts payable		$ 18,255	
Income taxes payable		6,200	
Interest payable		1,500	
Notes payable, due June 30, 2013		10,000	
Salaries and wages payable		4,200	
Total current liabilities			$ 40,155
Long-term debt:			
Bonds payable, due December 31, 2016			160,000
Total liabilities			$200,155

PROBLEM 2-3 (Concluded)

Stockholders' Equity		
Contributed capital:		
Capital stock, $10 par value,		
15,000 shares issued and outstanding..................	$150,000	
Paid-in capital in excess of par value	50,000	
Total contributed capital..	$200,000	
Retained earnings...	311,095	
Total stockholders' equity		511,095
Total liabilities and stockholders' equity		$711,250

2. Current Ratio = Current Assets/Current Liabilities

$86,250/$40,155 = 2.15 to 1

3. From the current ratio alone, Ruth appears to be relatively liquid. To fully assess its liquidity, however, it would be useful to look more specifically at the composition of the current assets and liabilities. How long does it take to sell inventory? How long does it take to collect an account receivable? Also, you would want to compare Ruth's current ratio at the end of this period with those of prior periods, and with the current ratio for companies in the same industry.

LO 4

PROBLEM 2-4 FINANCIAL STATEMENT RATIOS

1. a. Working capital at 12/31/12:

Current assets: $27,830 + $20,200 + $450 + $24,600 + $6,250 + $3,600 = $82,930
Current liabilities: $8,400 + $1,450 + $1,200 = $11,050
Working capital: $82,930 – $11,050 = $71,880

Working capital at 12/31/11:

Current assets: $35,770 + $19,450 + $700 + $26,200 + $5,020 + $4,800 = $91,940
Current liabilities: $5,200 + $1,200 + $12,000 + $1,230 + $1,600 = $21,230
Working capital: $91,940 – $21,230 = $70,710

b. Current ratio at 12/31/12:
$82,930/$11,050 = 7.50 to 1

Current ratio at 12/31/11:
$91,940/$21,230 = 4.33 to 1

PROBLEM 2-4 (Concluded)

2. Both the absolute liquidity position of the company and the relative liquidity position of the company have improved during 2012. First, the absolute position, as indicated by the amount of working capital, has improved from $70,710 to $71,880. The liquidity of the company has also improved on a relative basis, as indicated by the increase in the current ratio from 4.33 to 7.50. The primary reason for the improvement in the company's liquidity is the repayment during the year of the $12,000 note payable, along with the $1,200 of interest payable on the note. This is counterbalanced somewhat, though, by the decrease in accounts receivable from $35,770 to $27,830.

LO 4 **PROBLEM 2-5 WORKING CAPITAL AND CURRENT RATIO**

1. Current Ratio = Current Assets/Current Liabilities
= ($23,000 + $13,000 + $45,000 + $800)/($54,900 + $1,200)
= $81,800/$56,100 = 1.46 to 1

Working Capital = Current Assets – Current Liabilities
= $81,800 – $56,100 = $25,700

2. One concern is the relatively large percentage of the current assets tied up in inventory. This asset accounts for $45,000/$81,800, or 55% of the total current assets. What is the normal period of time it takes to sell inventory? Is any part of the inventory slow moving or obsolete?

3. On the basis of the current ratio alone, Stevenson appears to be relatively liquid, although it would be important to compare the ratio with those of prior years and with those of other companies in the same industry.

LO 5 **PROBLEM 2-6 SINGLE-STEP INCOME STATEMENT**

1. Single-step income statement:

SHAW CORPORATION
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

Revenues:		
Sales	$48,300	
Interest	1,340	
Rent	6,700	
Total revenues		$56,340
Expenses:		
Advertising	$ 1,500	
Commissions	2,415	
Cost of goods sold	29,200	
Depreciation—office building	2,900	
Income tax	1,540	
Insurance—salesperson's auto	2,250	
Interest	1,400	
Salaries and wages—office	12,560	
Supplies—office	890	
Total expenses		54,655
Net income		$ 1,685

2. A single-step income statement does not lend itself as readily to analysis as does a multiple-step statement. The lack of any grouping of the various expenses makes any type of analysis more difficult.

LO 5

PROBLEM 2-7 MULTIPLE-STEP INCOME STATEMENT AND PROFIT MARGIN

1. Multiple-step income statement:

SHAW CORPORATION
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

Sales		$48,300	
Cost of goods sold		29,200	
Gross profit			$ 19,100
Operating expenses:			
Selling expenses:			
Advertising	$ 1,500		
Commissions	2,415		
Insurance—salesperson's auto	2,250		
Total selling expenses		$ 6,165	
General and administrative expenses:			
Depreciation—office building	$ 2,900		
Salaries and wages—office	12,560		
Supplies—office	890		
Total general and administrative expenses		16,350	
Total operating expenses			22,515
Loss from operations			$ (3,415)
Other revenues and expenses:			
Interest expense		$ 1,400	
Interest revenue		1,340	
Rent revenue		6,700	
Excess of other revenues over other expenses			6,640
Income before taxes			$ 3,225
Income tax expense			1,540
Net income			$ 1,685

2. The main advantages of the multiple-step income statement are the groupings of various items and the provision of important subtotals such as income from operations.

3. Profit Margin = Net Income/Sales
= $1,685/$48,300 = 3.5%

4. A profit margin of 3.5% means that for every dollar of sales the company has net income of $0.035. This would appear to be a reasonable profit margin, but it would be important to compare the profit margin with prior years and with other companies in the same industry.

LO 8 **PROBLEM 2-8 STATEMENT OF CASH FLOWS**

1.

COLORADO CORPORATION
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2012

Cash flows from operating activities:		
Cash collected from customers	$ 93,970	
Cash paid for inventory	(65,600)	
Cash paid in salaries and wages	(20,400)	
Cash paid in taxes	(3,100)	
Net cash provided by operating activities		$ 4,870
Cash flows from investing activities:		
Payment on office building		(210,000)
Cash flows from financing activities:		
Proceeds from issuance of stock	$250,000	
Proceeds from long-term note	60,000	
Dividends declared and paid	(5,600)	
Net cash provided by financing activities		304,400
Net increase in cash		$ 99,270
Cash at beginning of year		0
Cash at end of year		$ 99,270

Note: Colorado should report one significant noncash activity as supplementary information to its statement of cash flows: the three-year, $90,000 note signed to finance the purchase of the office building.

2. First, the statement of cash flows reports on operations on a cash basis, as opposed to the income statement which is prepared on an accrual basis. Second, investing and financing activities are also reported on a statement of cash flows. For example, information about dividends paid during the year is shown on a statement of cash flows but not on an income statement. It is interesting to note that Colorado paid more in dividends, $5,600, than the amount of cash it generated from operations, $4,870.

LO 9

PROBLEM 2-9 BASIC ELEMENTS OF FINANCIAL REPORTS

Letter from the President to Stockholders of Grammar Inc.:

On the surface, 2012 does not appear to have been a successful year for Grammar Inc. One specific event, however, caused the net loss we experienced for the year. Operating income was $380,000 in 2012; however, the sale of a subsidiary at a loss of $400,000 resulted in a net loss for the year of $20,000. The sale of this unprofitable unit of the business should allow us to concentrate our attention in the future on our successful businesses and clear the way for a return to overall profitability in 2013.

I should point out to you that aside from the loss experienced on the sale of the subsidiary, 2012 was a very good year. We were able to control our operating expenses, as operating income as a percentage of sales increased from 20% to 38%. These are clear signals that Grammar is moving in the right direction and should have a solid year of operations in 2013.

MULTI-CONCEPT PROBLEMS

LO 2,4

PROBLEM 2-10 COMPARING THE COCA-COLA COMPANY AND PEPSICO

1. Current Assets – Current Liabilities = Working Capital (in millions)

The Coca-Cola Company:
($8,517 + $2,682 + $138 + $4,430 + $2,650 + $3,162) – ($8,859 + $8,100 + $1,276 + $273)
= $21,579 – $18,508 = $3,071

PepsiCo:
($5,943 + $426 + $6,323 + $3,372 + $1,505) – ($4,898 + $10,923 + $71)
= $17,569 – $15,892 = $1,677

$$\frac{\text{Current Assets}}{\text{Current Liabilites}} = \text{Current Ratio}$$

The Coca-Cola Company:
$21,579/$18,508 = 1.17:1

PepsiCo:
$17,569/$15,892 = 1.11:1

2. The two companies' current ratios are very similar. On the basis of these ratios, The Coca-Cola Company is slightly more liquid than PepsiCo.

3. The composition of a company's current assets adds another level to the analysis of liquidity. The Coca-Cola Company's cash and cash equivalents, the most liquid of assets, comprise nearly 40% of current assets. PepsiCo's cash and cash equivalents are about one-third of current assets. On the other hand, PepsiCo's accounts and notes receivable, also highly liquid, are 36% of current assets, contrasting with The Coca-Cola Company's accounts receivable of 21%. Although receivables are considered very liquid, questions may arise about collectibility.

LO 2,5

PROBLEM 2-11 COMPARABILITY AND CONSISTENCY IN INCOME STATEMENTS

1. The income statement for 2011 is in single-step format, and the 2012 statement uses the multiple-step format.

2.

GLEESON COMPANY
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2011

Sales	$1,500,000
Less: Cost of sales	450,000
Gross profit	$1,050,000
Selling expenses	$ 593,000*
Administrative expenses	94,000**
Total selling and administrative expenses	$ 687,000
Net income	$ 363,000

*$398,000 + $175,000 + $20,000
**$54,000 + $40,000

LO 1,4,8 **PROBLEM 2-12 CASH FLOW**

Cash available to pay a dividend on December 31, 2013:

Cash balance, September 30, 2013	$ 5,000
+ Accounts receivable collections	39,406*
+ Note receivable due on November 1	10,000
+ Interest due on November 1: $10,000 × 5%	500
– Cash paid for purchases	(15,762)**
– Mortgage note payments: 3 months × $1,200	(3,600)
– Operating expenses: 3 months × $3,000	(9,000)
Cash balance, December 31, 2013	$ 26,544

*September sales collected in October	$ 12,500
October sales collected in November:	
$12,500 × 1.05	13,125
November sales collected in December:	
$13,125 × 1.05	13,781
Total accounts receivable collections	$ 39,406

**September purchases paid for in October	$ 5,000
October purchases paid for in November:	
$13,125 × 40%	5,250
November purchases paid for in December:	
$13,781 × 40%	5,512
Total payments on account	$ 15,762

Note: Because inventory levels are maintained at $75,000, purchases are equal to 40% of sales each month.

Conclusion: 50,000 shares of common stock × $0.50 per share will require cash of $25,000 to pay the quarterly dividend. With $26,544 of cash available, Franklin will barely be able to meet the dividend payment. Unless one or more of the following actions are successful in increasing the cash balance, management should not recommend the normal quarterly dividend of $0.50 per share:

Reduce inventory levels.
Speed up the collection of receivables.
Lengthen the average amount of time taken to pay for purchases of inventory.
Reduce operating expenses.

ALTERNATE PROBLEMS

LO 2

PROBLEM 2-1A MATERIALITY

1. The pattern of long-distance calls might point to alternative long-distance plans with one of the many carriers now in this business. For example, some companies might give a discount for calls made in off-peak hours. The analysis might point to misuse by certain employees (overuse, personal use, etc.), a situation that could be corrected by talking to the employees who are misusing the long-distance service.

2. This question deals with the concept of materiality. It would be difficult to decide which of the two types of companies, a realtor or a hardware store, would make more long-distance calls. A realtor might make a large number of long-distance calls if it deals with out-of-state clients. The hardware store might regularly order inventory from vendors outside of its area code.

LO 2

PROBLEM 2-2A COSTS AND EXPENSES

1. **Point-of-sale systems in a retail store**—The cost associated with these systems is a tangible asset that should be reported in the Long-Term Assets section of the balance sheet and depreciated over the life of the systems; only a portion would be recognized as expense during the current period.

2. **An ad in the yellow pages**—All of the cost for the ad would normally be expensed in the period the cost is incurred unless there was evidence that the ad would provide benefits for a number of future periods.

3. **An inventory-control computer software system**—Assuming that the software was purchased, an intangible asset should be recognized and a portion of the cost recognized as expense in each of the periods benefited.

4. **Shipping merchandise for resale to chain outlets**—All of the costs associated with shipping merchandise for resale would normally be recognized as expense when the costs are incurred. Even though one could argue that under the matching principle these costs should be recognized as expense only when the inventory is sold, the practical difficulty in associating shipping costs with specific items sold results in most companies expensing these costs as incurred.

LO 3 **PROBLEM 2-3A CLASSIFIED BALANCE SHEET**

1. Classified balance sheet:

SINGER COMPANY
BALANCE SHEET
DECEMBER 31, 2012

Assets			
Current assets:			
Cash		$ 60,790	
Marketable securities		15,000	
Accounts receivable		26,700	
Merchandise inventory		112,900	
Prepaid rent		3,600	
Office supplies		400	
Total current assets			$219,390
Property, plant, and equipment:			
Land		$250,000	
Buildings	$150,000		
Less: Accumulated depreciation	40,000	110,000	
Equipment	$ 84,500		
Less: Accumulated depreciation	12,500	72,000	
Total property, plant, and equipment			432,000
Intangible assets:			
Patents			45,000
Total assets			$696,390
Liabilities			
Current liabilities:			
Accounts payable		$ 34,280	
Income taxes payable		7,500	
Interest payable		2,200	
Notes payable, due April 15, 2013		6,500	
Salaries payable		7,400	
Total current liabilities			$ 57,880
Long-term debt:			
Bonds payable, due December 31, 2018			250,000
Total liabilities			$307,880

PROBLEM 2-3A (Concluded)

Stockholders' Equity		
Contributed capital:		
Capital stock, $1 par value, 200,000 shares issued and outstanding	$200,000	
Paid-in capital in excess of par value	75,000	
Total contributed capital	$275,000	
Retained earnings	113,510	
Total stockholders' equity		388,510
Total liabilities and stockholders' equity		$696,390

2. Current Ratio = Current Assets/Current Liabilities
$219,390/$57,880 = 3.79 to 1

3. From the current ratio alone, Singer appears to be relatively liquid. In fact, Singer may be too liquid, in that its cash balance is greater than its total current liabilities. Singer may be missing significant investment opportunities by maintaining such a large cash balance. To fully assess its liquidity, it would be useful to look more specifically at the activity in accounts receivable and merchandise inventory. How long does it take to collect an account receivable? How long does it take to sell inventory? Also, you would want to compare Singer's current ratio at the end of this period with prior periods, and with the current ratio for companies in the same industry.

LO 4 **PROBLEM 2-4A FINANCIAL STATEMENT RATIOS**

1. a. Working capital at 12/31/12:

Current assets: $16,500 + $12,750 + $200 + $900 + $400 = $30,750
Current liabilities: $10,500 + $1,800 + $10,000 = $22,300
Working capital: $30,750 – $22,300 = $8,450

Working capital at 12/31/11:

Current assets: $26,000 + $11,800 + $1,100 + $250 = $39,150
Current liabilities: $6,500 + $800 + $5,800 = $13,100
Working capital: $39,150 – $13,100 = $26,050

b. Current ratio at 12/31/12:
$30,750/$22,300 = 1.38 to 1

Current ratio at 12/31/11:
$39,150/$13,100 = 2.99 to 1

PROBLEM 2-4A (Concluded)

2. Both the absolute liquidity position of the company and the relative liquidity position of the company have declined during 2012. First, the absolute position, as indicated by the amount of working capital, has decreased from $26,050 to $8,450. The liquidity of the company has also decreased on a relative basis, as is indicated by the decrease in the current ratio from 2.99 to 1.38. The primary reasons for the decline in the company's liquidity are the significant increases in accounts payable and taxes payable and the decrease in accounts receivable.

LO 4

PROBLEM 2-5A WORKING CAPITAL AND CURRENT RATIO

1. Current Ratio = Current Assets/Current Liabilities
= ($23,000 + $43,000 + $75,000 + $2,800)/($84,900 + $3,200)
= $143,800/$88,100 = 1.63 to 1

Working Capital = Current Assets – Current Liabilities
= $143,800 – $88,100 = $55,700

2. Even though Kapinski has a current ratio that is over 1 to 1, it may experience trouble paying its bills, specifically its accounts payable. This depends on two factors: (1) how long it normally takes to collect accounts receivable and (2) the normal length of time to sell inventory. In addition, the company must be concerned about whether any portion of the accounts receivable may prove to be uncollectible and whether any portion of the inventory is not saleable.

3. Three things Kapinski might be able to do to help it pay its bills on time:

a. Decrease the average collection period for accounts receivable.

b. Negotiate with suppliers to increase the time Kapinski is given to pay for its accounts payable.

c. Reduce its inventory levels.

LO 5 **PROBLEM 2-6A SINGLE-STEP INCOME STATEMENT**

1. Single-step income statement:

CORBIN ENTERPRISES
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

Revenues:		
Sales	$350,000	
Dividend	2,700	
Total revenues		$352,700
Expenses:		
Cost of goods sold	$150,000	
Wages—office	45,600	
Income tax	30,700	
Rent—office	26,400	
Rent—salesperson's car	18,000	
Advertising	9,000	
Utilities	6,750	
Depreciation—computer	4,500	
Interest	1,900	
Supplies—office	1,300	
Total expenses		294,150
Net income		$ 58,550

2. A single-step income statement does not lend itself as readily to analysis as does a multiple-step statement. The lack of any type of grouping of the various expenses makes any type of analysis more difficult.

LO 5

PROBLEM 2-7A MULTIPLE-STEP INCOME STATEMENT AND PROFIT MARGIN

1. Multiple-step income statement:

CORBIN ENTERPRISES
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

Sales		$350,000	
Cost of goods sold		150,000	
Gross profit			$200,000
Operating expenses:			
Selling expenses:			
Advertising	$ 9,000		
Rent—salesperson's car	18,000		
Total selling expenses		$ 27,000	
General and administrative expenses:			
Depreciation—computer	$ 4,500		
Rent—office	26,400		
Supplies—office	1,300		
Wages—office	45,600		
Utilities	6,750		
Total general and administrative expenses		84,550	
Total operating expenses			111,550
Income from operations			$ 88,450
Other revenues and expenses:			
Interest expense		$ 1,900	
Dividend revenue		2,700	
Excess of other revenues over other expenses			800
Income before taxes			$ 89,250
Income tax expense			30,700
Net income			$ 58,550

2. The main advantages of the multiple-step income statement are the groupings of various items and the provision of important subtotals such as income from operations.

3. Profit Margin = Net Income/Sales
= $58,550/$350,000 = 16.7%

4. A profit margin of 16.7% means that for every dollar of sales the company has net income of $0.167. This would appear to be a good profit margin, but it would be important to compare the profit margin with prior years and with other companies in the same industry.

LO 8

PROBLEM 2-8A STATEMENT OF CASH FLOWS

1.

WISCONSIN CORPORATION
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2012

Cash flows from operating activities:		
Cash collected from customers	$ 310,000	
Cash paid for inventory	(185,000)	
Cash paid in salaries and wages	(30,100)	
Cash paid in taxes	(40,000)	
Net cash provided by operating activities		$ 54,900
Cash flows from investing activities:		
Purchase of manufacturing facility		(150,000)
Cash flows from financing activities:		
Proceeds from issuance of stock	$ 400,000	
Proceeds from long-term note	50,000	
Dividends declared and paid	(4,000)	
Net cash provided by financing activities		446,000
Net increase in cash		$ 350,900
Cash at beginning of year		0
Cash at end of year		$ 350,900

Note: Wisconsin should report one significant noncash activity as supplementary information to its statement of cash flows: the five-year, $150,000 note signed to finance the purchase of the manufacturing facility.

2. First, the statement of cash flows reports on operations on a cash basis, as opposed to the income statement which is prepared on an accrual basis. Second, investing and financing activities are also reported on a statement of cash flows. For example, information about dividends paid during the year are shown on a statement of cash flows but not on an income statement.

LO 9

PROBLEM 2-9A BASIC ELEMENTS OF FINANCIAL REPORTS

Letter from the President to Stockholders of Thesaurus Inc.:

Thesaurus Inc. has just completed another very successful year. The decrease in net income from 2011 to 2012 was due to a single, nonrecurring gain in 2011, a $400,000 gain on the sale of a subsidiary in that year. A comparison of the operating income of the two years shows a distinct improvement, from $100,000 in 2011 to $380,000 in 2012.

All signs point to a successful year just completed. We were able to control our operating expenses: operating income as a percentage of operating revenues increased from 50% to 76%. These are clear signals that Thesaurus is moving in the right direction and should have a solid year of operations in 2013.

ALTERNATE MULTI-CONCEPT PROBLEMS

LO 2,4

PROBLEM 2-10A COMPARING STARWOOD HOTELS & RESORTS AND HYATT HOTELS CORPORATION AND SUBSIDIARIES

1. Current Assets – Current Liabilities = Working Capital (in millions)

Starwood Hotels & Resorts:
($753 + $53 + $513 + $802 + $59 + $126) – ($9 + $138 + $127 + $1,104 + $410 + $373) = $2,306 – $2,161 = $145

Hyatt Hotels Corporation and Subsidiaries:
($1,110 + $106 + $524 + $199 + $100 + $73 + $6 + $29 + $18) – ($57 + $145 + $286 + $108) = $2,165 – $596 = $1,569

Current ratio:

Starwood Hotels & Resorts:
$2,306/$2,161 = 1.07:1

Hyatt Hotels Corporation and Subsidiaries:
$2,165/$596 = 3.63:1

2. Based on both the amount of working capital and the current ratio, Hyatt appears to be more liquid than Starwood. Hyatt's current ratio is over three times Starwood's ratio.

3. Starwood's cash and cash equivalents make up 33% of its total current assets, while for Hyatt this ratio is 51%. Therefore, not only does Hyatt have a much higher current ratio, but it is also more liquid based on the ratio of its cash and cash equivalents to its total current assets.

LO 2,5

PROBLEM 2-11A COMPARABILITY AND CONSISTENCY IN INCOME STATEMENTS

1. The income statements for both years are in single-step form.

2. Income statement items as a percentage of sales:

	2012	**2011**
Sales	100.0%	100.0%
Cost of sales	36.0	30.0
Sales salaries	25.1	26.5
Delivery expense	10.6	11.7
Office supplies	3.2	3.6
Depreciation—truck	2.4	2.7
Computer line expense	1.4	1.3
Total expenses	78.7%	75.8%
Net income	21.3%	24.2%

Restating each item on the income statement as a percentage of sales allows the reader to better understand how successful a business was in controlling costs. For example, Chisholm Company increased its sales by $200,000 for the year, but this did not translate to an increase in the bottom line, i.e., net income. The restatement of each of the expenses as a percentage of sales reveals why net income did not increase. Total expenses, as a percentage of sales, increased from 75.8% to 78.7%. Aside from a slight increase in one of the minor expenses, computer lines, only one other expense increased as a percentage of sales. The primary reason for the increase in expenses as a percentage of sales was the increase in the cost of Chisholm's products from 30% to 36% of sales.

LO 1,4,8 **PROBLEM 2-12A CASH FLOW**

Cash available to pay a dividend on December 31, 2013:

Cash balance, December 1, 2013	$ 15,000
+ Cash collections from November 2013 sales	40,000*
– Operating expenses	(10,000)
– Payroll: 2 × $4,500	(9,000)
Cash balance, December 31, 2013	$ 36,000

*Accounts receivable balance on December 1.

Conclusion: Roosevelt has $50,000 par value of stock, with the par value of each share set at $2. Thus, there are 25,000 shares of stock outstanding. At $1 per share in dividends, $25,000 in cash will be needed to meet the annual dividend payment. On the surface, it appears that Roosevelt should have no trouble in paying its annual dividend—the above analysis indicates a December 31, 2013, cash balance of $36,000. However, the $30,000 note payable, along with six months' interest of $450 ($30,000 × 3% × 6/12), will be due two weeks into the new year (January 15, 2014). If we assume that accounts receivable are collected relatively evenly over the month, the balance available to repay the $30,000 note and interest on January 15, 2014, would be only $29,000:

December sales $40,000 × 95%	$ 38,000
– Unearned revenue already collected	(2,000)
December sales collected in January	$ 36,000
Divided by 2 (assuming receivables are collected ratably over the month)	÷ 2
Cash available on January 15 from December sales	$ 18,000
+ Cash available, December 31, 2013	36,000
– Dividend payment	(25,000)
Cash available to repay note and interest	$ 29,000

Conclusion: Roosevelt should not declare its normal annual dividend of $1 per share.

DECISION CASES

READING AND INTERPRETING FINANCIAL STATEMENTS

LO 4

DECISION CASE 2-1 COMPARING TWO COMPANIES IN THE SAME INDUSTRY: GENERAL MILLS AND KELLOGG'S

(Amounts in millions of dollars)

1. General Mills:

5/30/10 Working capital:	\$3,480.0 – \$3,769.1 = (\$289.1)
5/31/09 Working capital:	\$3,534.9 – \$3,606.0 = (71.1)
Change in working capital:	(\$289.1) – (\$71.1) = (\$218.0)

Kellogg's:

1/1/11 Working capital:	\$2,915 – \$3,184 = (\$269)
1/2/10 Working capital:	\$2,558 – \$2,288 = \$270
Change in working capital:	(\$269) – \$270 = (\$539)

2. General Mills:

5/30/10 Current ratio:	\$3,480.0/\$3,769.1 = 0.92:1
5/31/09 Current ratio:	\$3,534.9/\$3,606.0 = 0.98:1
Percentage change in ratio:	(0.92 – 0.98)/0.98 = 6% decrease

Kellogg's:

1/1/11 Current ratio:	\$2,915/\$3,184 = 0.92:1
1/2/10 Current ratio:	\$2,558/\$2,288 = 1.12:1
Percentage change in ratio:	(0.92 – 1.12)/1.12 = 18% decrease

3. Inventories and receivables, in that order, are the largest current assets for General Mills. For Kellogg's, accounts receivable and inventories, in that order, are the most significant current assets. The next largest current asset for both companies is their cash and cash equivalents.

4. Both companies showed a decline in their current ratios, a 6% decrease for General Mills and 18% for Kellogg's. Inventories, which are further removed from cash than are receivables, are slightly more significant for General Mills than for Kellogg's.

LO 4

DECISION CASE 2-2 READING GENERAL MILLS'S BALANCE SHEET

1. Inventories is the largest of General Mills's current assets on May 30, 2010. It represents $1,344.0 million/$3,480.0 million, or 38.6% of the total current assets. Inventories consist of raw materials, work-in-process, and finished goods and is the lifeblood of a company that makes products for resale to customers.

2. The second largest of General Mills's current assets is Receivables. This asset represents $1,041.6 million/$3,480.0 million, or 29.9% of total current assets on May 30, 2010. A large receivables balance is an indication that the company has been successful in selling its products; however, it also means that the company has to be diligent in collecting the amounts due from customers.

3. Inventories increase as the various products, such as breakfast cereals, are made and the account decreases when the products are sold to customers. Receivables increase when General Mills sells its products to its customers and decrease when cash is collected from them.

MAKING FINANCIAL DECISIONS

LO 8

DECISION CASE 2-3 ANALYSIS OF CASH FLOW FOR A SMALL BUSINESS

All financial decisions involve a trade-off between risk and return. The offer to work for an investment firm for $40,000 per year may be much less risky than running one's own business. Charles needs to consider, however, how likely it is that the employment with the investment firm will continue indefinitely. For example, could a downswing in the economy cause the firm to cut Charles's position?

Charles has experienced for himself the risks and rewards of running a business. To date, the business has not produced significant profits: only $11,500 over a two-year period. However, the significant increase in commissions revenue from one year to the next is very encouraging. This is an example of the potential rewards of running a business.

This case also illustrates the difference between income and cash flow. Because depreciation is not a cash flow, there is a significant difference between the cash flow for each of the two years and net income. Assuming that the revenues and all of the expenses other than depreciation result in cash flows of the business, the cash inflow for the first year is ($11,000) + $15,000 (add-back of depreciation), or $4,000. The cash inflow for the second year is even better, after adjusting for depreciation: $22,500 + $15,000, or $37,500.

LO 9

DECISION CASE 2-4 FACTORS INVOLVED IN AN INVESTMENT DECISION

Sections of the annual report that should be read in comparing investment alternatives:

1. **Financial statements, including income statement, balance sheet, statement of stockholders' equity, and statement of cash flows**—The statements give an overall picture of the financial position and results of operations of the companies.
2. **Notes to the financial statements**—The notes are an integral part of the financial statements. They give the reader an indication of the accounting policies used; the various legal obligations, such as those for leases and pension plans; the composition of the long-term assets; and many other details.
3. **Management's discussion and analysis**—This report by management will reveal how management views the year just completed in comparison to prior years and how it feels about the company's prospects in the future.
4. **Other information contained in the annual report**—This might include descriptions of the company's services as well as plans for expansion and other nonfinancial information. The investor may also want to consult various trade publications for insights into the industry.

ETHICAL DECISION MAKING

LO 2

DECISION CASE 2-5 THE EXPENDITURE APPROVAL PROCESS

The sales rep should be skeptical about Roberto's request for two separate bills for $900 each. If the rep is aware that the request was made to circumvent a corporate policy, it would be unethical of the rep to comply with the request. This certainly puts the rep in a predicament: should he or she risk losing the sale by refusing to write up two separate bills?

Roberto is not acting in an ethical manner by requesting two bills, given that it is a deliberate attempt on his part to circumvent corporate policy. He may not agree with the policy, but it is not ethical to devise a scheme to work around the policy. Instead, he should write a memo to the corporate chief financial officer to explain his dissatisfaction with the policy and why it is not appropriate in this particular situation.

Whether or not the corporate policy is appropriate is difficult to answer without additional information. At the very least, it seems unreasonable that it should take three weeks for the approval process.

LO 4,6

DECISION CASE 2-6 SUSAN APPLIES FOR A LOAN

1. The ethical dilemma for you is whether you should present financial statements to the banker that are incomplete (that make Susan's financial position appear to be better than it actually is). Your decision affects not only Susan but also the banker. Susan would benefit from a balance sheet that does not accurately reflect all of her debts, but the banker would likewise be harmed. Your responsibility is to present a balance sheet that accurately reflects all of Susan's debts.

2. If the balance sheet is not provided, the banker will not have all the relevant information useful to the decision process. Without the balance sheet the banker will not be able to predict future cash outflows related to the company's debt. Also, the information is not neutral because it is presented to show the company's financial health as better than it is.

3. You should provide the balance sheet to the bank. If the banker does not receive the balance sheet and makes a decision only based on the income statement, this user of the information will not evaluate the risk of the company correctly. It is unlikely that the banker would consider making the loan on the basis of the quarterly income statements alone. The most recent balance sheet tells the banker about the overall financial strength of the company, and it is an integral part of any loan analysis. As the chief financial officer for the organization, you have a responsibility to provide the banker with the necessary information needed to make an informed decision on the loan. Susan would rather not show the banker the balance sheet because it would reveal the substantial loan already on the books. You are obligated, however, to provide the balance sheet to the bank if it would be relevant to the bank's decision. Without it, it is unlikely the bank will make the loan.

REAL WORLD PRACTICE 2.1

The amount of working capital at May 30, 2010, was $3,480.0 million – $3,769.1 million = ($289.1) million. On May 31, 2009, the working capital amounted to $3,534.9 – $3,606.0 = ($71.1) million. Total assets decreased during the year.

REAL WORLD PRACTICE 2.2

Net income increased over the three years from $1,294.7 million in the 2008 fiscal year to $1,530.5 million in the 2010 fiscal year, an increase of $235.8 million. This represents a percentage increase of $235.8/$1,294.7, or 18.2%. During this same time period, net sales increased from $13,652.1 million to $14,796.5 million, an increase of $1,144.4 million. This represents a percentage increase of $1,144.4/$13,652.1, or 8.4%. Thus, net income increased at a higher percentage than did net sales; this is an indication that the company is successfully controlling its costs.